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Spain: The Economic Slowdown

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An Intelligence Assessment

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An Intelligence Assessment

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Spain: The Economic Slowdown

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Key Judgments

Information available as of 21 November 1984 was used in this report.

Spain's real economic growth sank from an average annual rate of 7 percent during the "miracle" years, 1960-74, to 1.6 percent during 1975-83. The slowdown was due to a variety of factors, including skyrocketing real labor costs, the 1973/74 and 1979/80 oil price shocks and ensuing worldwide recessions, structural problems, some wrong-headed government policies, and demographic trends. Put simply, the external environment deteriorated drastically, and Spanish policymakers—distracted by the difficult task of building a new democracy—made a bad situation worse. The result was a collapse of investment spending, the main engine of growth during the boom years. 25X1

Adverse worldwide industrial trends hit Spain at an extremely inopportune time in the mid-1970s. The Franco regime had concentrated its development planning and spending on the very industries most affected by the global economic slowdown—steel, textiles, and shipbuilding, in particular. Post-Franco governments compounded this mistake by sinking more money into the wrong industries and boosting social welfare programs and wages to catch up with northern European countries. Many Spanish institutions and major portions of the economy, however, were still only semideveloped and in some respects proved as fragile as the business cycle itself. 25X1

Prime Minister Felipe Gonzalez's Socialist government appears determined to carry out an ambitious and painful adjustment aimed at trimming inflation and the budget deficit and making Spanish industry more competitive. The program includes a deal worked out with the Socialist General Union of Workers (UGT) trade union to curb wage gains during 1985-86 and aims to rationalize overstaffed and debt-ridden firms, return some of the major money-losing public-sector enterprises to the private sector, and promote investment in new industries. 25X1

Progress has thus far been limited. The Socialists trimmed the current account deficit to $2.5 billion and brought inflation down to 12 percent last year. They no longer publicly maintain that their policies have begun to foster the job creation promised during the 1982 election campaign and admit that the unemployment rate will not decline from its current 20 percent until next year at the earliest. Real wage losses and layoffs at inefficient plants will cost the Socialist government some support from workers and may lead to sporadic strikes. However, Gonzalez's popularity, a large underground economy, and the UGT's desire to cooperate and negotiate with a Socialist-led administration suggest that serious social disruptions remain unlikely. 25X1

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Reflecting the effects of Socialist policies, the economy should post at least a 2.5-percent growth rate this year, an improvement over its 1975-83 performance. Exports will be the source of most of the growth, increasing by over 10 percent in volume; on the other hand, real investment and private consumption probably will fall. Soft domestic demand should help cut 3 percentage points off the inflation rate and turn last year's current account deficit into a surplus. 25X1

Over the longer run, we believe that an appreciable improvement over the record of the last decade is reasonably certain, but a return to the miracle years can be ruled out. Because Spain directs over half its exports to northern European countries, its average annual growth rate through 1990 probably will not be much better than 3 percent if, as we expect, West European average annual growth is held to less than 2.5 percent. Moreover, we anticipate that, if Spain joins the EC in 1986, it will face a somewhat bumpy transition period as it lowers its tariffs to EC levels and exposes its highly protected domestic industries to greater competition from more efficient multinationals. 25X1

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Spain: The Economic Slowdown

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Introduction

Spain has gone through two distinct economic periods in the last 25 years. The efforts of the authoritarian Franco regime to develop the country's industrial base led to a period of rapid growth during 1960-74—the so-called miracle years. This has been followed by a prolonged recession beginning in 1975 and coinciding with the restoration of democracy. This paper will explore the international and national economic trends behind the turnaround. It also will assess the difficulties facing the Socialist government of Prime Minister Gonzalez as it tries to cure Spain's deep-rooted problems and put the country on a higher growth path.

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The Economic Miracle: 1960-74

The Spanish economy, weakened by the postwar international isolation of the Franco regime and its efforts to promote autarchy, did not really take off until 1960. During 1960-74, however, it grew an average 7.3 percent per year in real terms—a rate exceeded only by Japan within the OECD (see figure 1). The boom was led by industrial production, which expanded at an average annual pace of 11.3 percent. This rapid economic growth fueled a remarkable rise in living standards, as per capita real GNP rose at a 6.2-percent annual rate. In terms of constant 1980 prices and exchange rates, per capita GNP grew from $2,325 in 1960 to $5,389 in 1974—from 32 percent of the US level to 52 percent.

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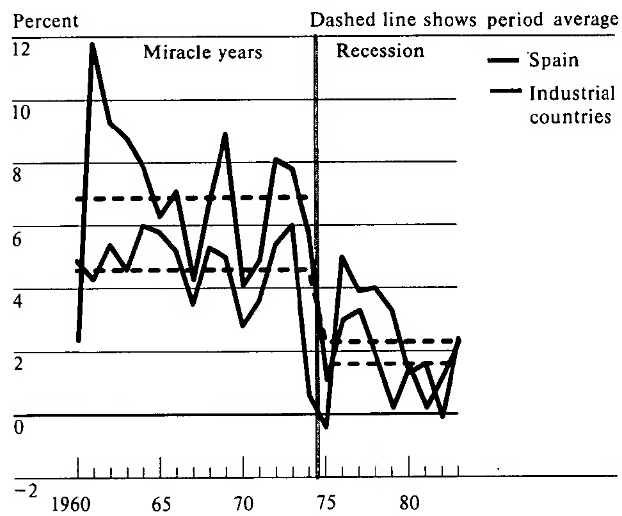
Spain's remarkable economic performance was fueled primarily by the Franco regime's decision in 1959 to relax trade and investment controls and to implement a major devaluation of the peseta. Until then, high tariffs, import restrictions, and an overvalued exchange rate had strangled domestic production and constrained exports, in part because of Spain's dependence on imports of capital goods and raw materials. With the loosening of controls, imports of capital goods and machinery soared, as did foreign

Figure 1
Spain: Comparative Real GDP Growth Rates, 1960-83



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investment, helping to push real investment up by an average annual rate of 10.5 percent during 1960-74 and raising its share of GDP from 17.9 percent to 24.7 percent (see figure 2). In our judgment, this growth of investment was the major driving force behind the economic boom. Exports probably were the second most important engine of growth. After a 50-percent leap in 1960 in response to the sharp devaluation of the peseta, export volume expanded at an average annual pace of 11.9 percent during 1961-74—the third-highest rate in the OECD (see figure 3).

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Figure 2
Spain: Real Investment Growth, 1960-83

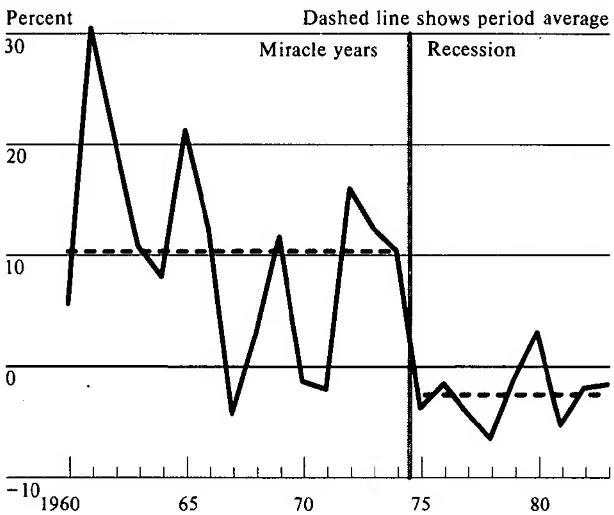

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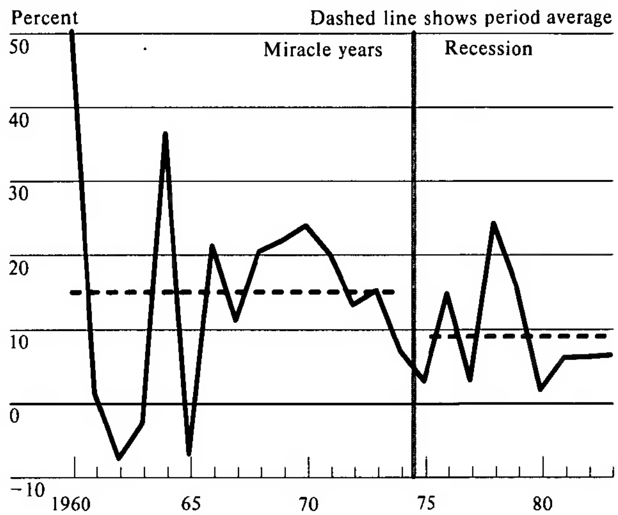
Figure 3
Spain: Export Volume, 1960-83



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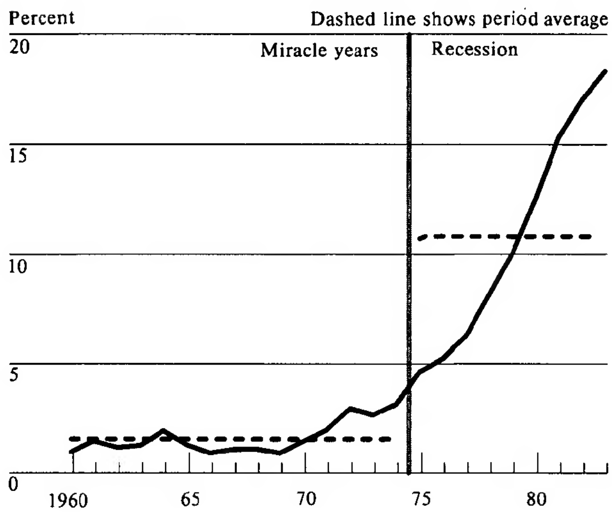
Rapid economic growth enabled Spain to cope with some dramatic structural shifts, notably the displacement of 1.8 million farmworkers. Between 1960 and 1974, the proportion of workers employed in the agricultural sector fell from 41 percent to 23 percent as rising farm wages and government incentive programs prompted landowners to introduce labor-saving devices. Meanwhile, the total labor force increased by about 1.5 million, with women accounting for about two-thirds of this gain as the female labor force participation rate rose from 26 percent to 33 percent, and the male participation rate declined. Unemployment stayed below 4 percent, however, as the services and industrial sectors each generated about 1.5 million new jobs. A substantial net outflow of workers—mainly to northern Europe—also helped to hold down unemployment.

Spain's remarkable growth performance was achieved without creating major economic disequilibrium. The current account remained relatively stable up to 1974 due to strong foreign demand for Spanish exports, tourism revenues, and worker remittances. Until the first oil price shock, the occasional current account deficit never exceeded $600 million. Price increases were something of a problem, as Spain's average inflation rate ran at 7.5 percent annually—3 percentage points above the OECD average. However, with wage hikes based on productivity and the peseta depreciating against competitors' currencies, the regime kept relative unit labor costs fairly steady, thus protecting export competitiveness. 25X1

The Slowdown

Spain's economic performance slid dramatically during 1975-83. Average annual real GDP growth dropped to 1.6 percent, and Spain's growth ranking within the OECD fell from second to 16th. Moreover, 25X1

Figure 4
Spain: Unemployment Rate, 1960-83



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the 5.7-percentage-point decline in the growth rate from the 1960-74 period was the sharpest drop recorded in any OECD country. On the whole, domestic demand nearly stagnated, mirroring a slowdown in the growth of private consumption and an average annual decline of 2 percent in real investment. Manufacturing output grew only about 1 percent annually on average—barely one-tenth of its earlier pace—while construction activity declined by a total of 20 percent.

In contrast with the record of steady job creation and low unemployment during the boom years, the last 10 years have seen a loss of jobs and a sixfold increase in unemployment (see figure 4). The jobless rate stood at 20 percent in mid-1984—the highest rate of unemployment in Western Europe except for Turkey. More than 2 million jobs have been lost—about equally divided between industry and agriculture—and fewer people are employed now than in 1952. The problem of unemployment is particularly acute for young people. At the end of last year, 38 percent of those in the 20-to-24 age bracket could not find a job, and the teenage unemployment rate was even higher. 25X1

Spain's external accounts deteriorated sharply, and severe inflationary pressures built up in the mid-1970s (see table 1 and figure 5). The quadrupling of world oil prices in 1973/74 was a major blow, causing a swing from a current account surplus of $560 million in 1973 to a deficit of $3.2 billion in 1974. World recession and uncertainties about Spain's political future caused a drop in tourism and worker remittances that widened the deficit to $4.3 billion in 1976, equivalent to 4 percent of GDP. 25X1

Although the current account returned to surplus in 1978 and 1979, the second round of OPEC price hikes triggered another series of deficits, peaking at $5.2 billion in 1980. Post-Franco Spain has also been plagued with a persistently high rate of inflation. In 1976 and 1977, consumer price inflation was 17 percent and 24 percent, respectively—nearly three times the average for Spain's major trading partners. Tighter economic policies have gradually slowed inflation—to 12 percent in 1983—but it is still running at roughly double the pace in other industrial countries. 25X1

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The one bright spot during this period was the rapid growth of export volume: although down by one-fourth from the earlier period, the average annual growth rate of 9.1 percent was still the second best in the OECD. Even this had its dark side, however. Many of the export gains simply reflected the collapse of the domestic market and were achieved only by slashing profit margins. 25X1

Causes

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There is neither a simple nor a single explanation for the change in Spain's economic fortunes. Spain suffered along with other industrial countries from the 1973/74 and 1979/80 oil price shocks and ensuing worldwide recessions, and it too was hit by intensifying competition from the newly industrializing countries (NICs). There were also structural problems at

Table 1
Spain: Balance of Payments

Million US $

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983 [a]
Current account balance	557	−3,244	−3,488	−4,299	−2,450	1,574	1,109	−5,188	−4,980	−4,217	−2,533
Trade balance	−3,545	−7,069	−7,386	−7,327	−6,221	−4,083	−5,687	−11,725	−10,115	−9,181	−7,402
Exports, f.o.b.	5,402	7,265	7,807	8,990	10,611	13,480	18,352	20,581	20,971	21,332	20,832
Imports, f.o.b.	8,947	14,334	15,193	16,317	16,832	17,563	24,039	32,306	31,086	30,513	28,234
Services, net	2,688	2,679	2,755	1,886	2,620	4,001	5,014	4,489	3,443	3,383	3,698
Of which:											
Tourism	2,872	2,869	3,096	2,690	3,486	4,917	5,558	5,720	5,709	6,122	5,942
Transfers, net	1,414	1,146	1,143	1,142	1,151	1,656	1,782	2,048	1,692	1,581	1,171
Long-term capital, net	765	1,669	1,803	1,920	3,219	1,898	3,216	4,252	4,294	1,827	3,089
Short-term capital, errors, and omissions	1,299	843	1,465	1,579	376	417	−1,340	−406	−94	−1,096	−882
Change in reserves	1,299	−732	−220	−800	1,145	3,889	2,985	−1,342	−780	−3,486	−326

[a] Preliminary.

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home, notably the fact that the earlier investment boom had peaked just as the global economic downturn was beginning and had concentrated heavily in basic products whose markets were to fare poorly in the post-1973 world.

The combination of these factors probably made a sharp slowdown in Spanish economic growth inevitable. The fact that Spain has done so much worse than the other industrial countries, however, is largely attributable to the policy mistakes of post-Franco governments. These mistakes have included inappropriate fiscal and exchange rate policies, market-distorting oil price controls, and encouragement of inefficient public-sector enterprises. Skyrocketing labor costs—in part a product of the new democracy's efforts to build support—have also been a major factor adding to the country's problems.

It should also be noted that the actual deterioration of the Spanish economy is probably not quite as bad as the official statistics suggest because of the existence of a large underground economy. The underground sector almost certainly has expanded since 1974 in response to layoffs and a rising tax burden, thus generating jobs and output that are not officially recorded. But even if the underground economy is as large as one Spanish study suggests (23 percent of GDP), and even if its absolute size has doubled since 1974, the increment to Spain's official GDP growth rate would be only 1 percentage point annually. We suspect that the actual figure is less than this because the above assumptions probably overstate the size and growth of the underground economy. 25X1

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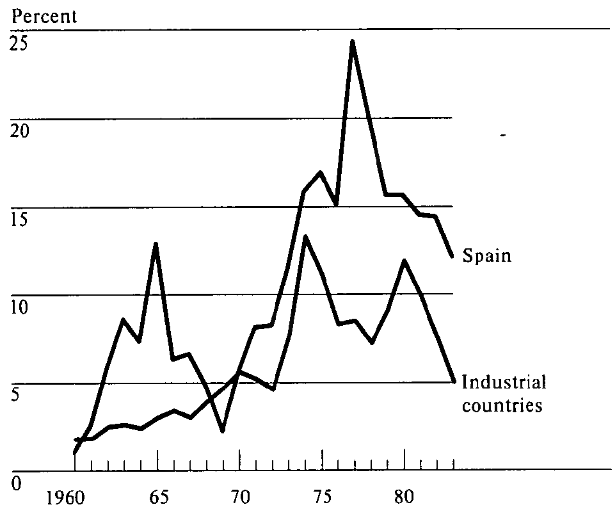
External Causes

The Oil Price Shocks. Spain was marginally more vulnerable than most other Western countries to the two rounds of OPEC price hikes because oil accounted for 68 percent of its energy consumption in 1973, compared with 61 percent for the EC and 60 percent for Western Europe as a whole. Spain was particularly ill prepared for the second shock because in 1980 it

Figure 5
Spain: Comparative Inflation Rates, 1960-83



[redacted]

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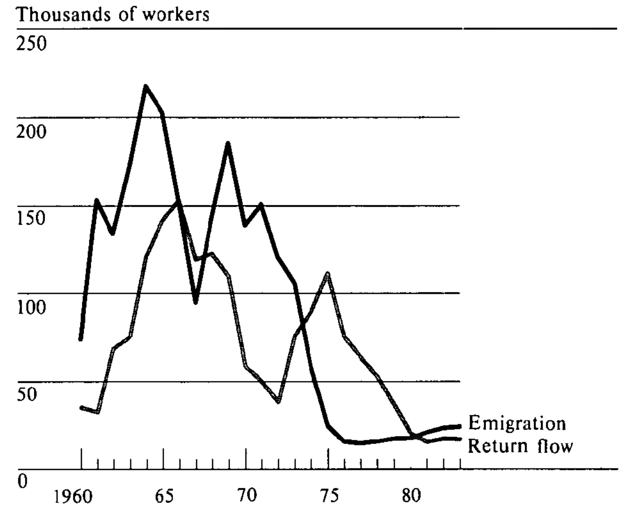
Figure 6
Spain: Migration Flows, 1960-83



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[redacted]

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was still covering 68 percent of its energy needs with oil while the EC and Western Europe as a whole had cut their oil dependence to 52 percent and 53 percent, respectively. [redacted]

The combination of rising oil consumption and sharply higher oil prices quadrupled Spain's oil import bill from $1.1 billion in 1973 to $4.5 billion in 1976. This accounted for about 70 percent of the deterioration in the current account during these years. The second round of oil price hikes in 1980 more than doubled the cost of oil imports again, to $11.2 billion, and brought another sharp deterioration in the current account. As elsewhere, this sudden outflow of purchasing power exerted a substantial contractionary effect. [redacted]

World Recessions. The world recessions triggered by the two oil price shocks dealt a hard blow to foreign demand for Spanish goods. Average annual real GDP growth for the industrial OECD countries—which account for approximately two-thirds of Spain's exports—fell from 4.6 percent during 1960-74 to 2.2 percent during 1975-83. Perhaps even more important, the West European slump hurt Spain's earnings from tourism and worker remittances. As West European governments began to limit the number of incoming foreigners and to encourage guest workers to go home, the social safety valve of emigration was lost; in 1975-80 only 105,000 Spanish workers emigrated, whereas approximately 360,000 emigrants returned (see figure 6). Although Madrid estimates that net outflows are once again occurring, the average rate for the last three years is put at only 23,000. The recession abroad—probably abetted by Spain's worsening price competitiveness—has also cut into earnings from tourism and other services. Net earnings from services and transfers covered only 17 percent of Spanish imports in 1983, down from 46 percent a decade earlier. [redacted]

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Intensifying Foreign Competition. Intense competition from developing countries in traditional export sectors like footwear, textiles, steel, shipbuilding, and

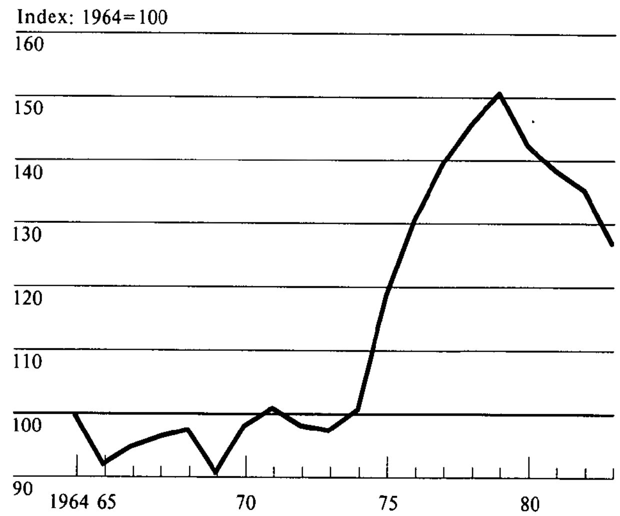
leather has hurt Spain's export earnings. Spanish firms boosted production of traditional products in the 1970s—at precisely the time of a major export push by the newly industrializing countries—Brazil, Mexico, Singapore, Hong Kong, South Korea, and Taiwan. Handicapped by higher labor costs and a strong peseta, Spanish exporters could not afford to lower their prices enough to compete with the NICs. While the NICs' share of OECD imports of these commodities quadrupled from 1970 to 1982, Spain's market share rose only 2 percentage points from 1970 to 1978, fell for a few years, and then began rising again in 1982 as the peseta depreciated. 25X1

Deteriorating Terms of Trade. Partly because of the factors mentioned above, Spain's terms of trade (export prices relative to import prices) have deteriorated sharply since 1973. Although all oil-importing countries faced this problem to some degree, the deterioration for Spain—about 33 percent between 1973 and 1980—was roughly twice that experienced by the OECD industrial countries as a group. This reflected Spain's above-average dependence on oil imports and its export concentration in basic products whose prices have not kept up with inflation. It should be noted, however, that the sharp relative deterioration in Spain's terms of trade (compared with the other industrial countries) actually began in 1968. Thus, while it undoubtedly added to Spain's problems after 1974, it clearly was only one of several causes. 25X1

Internal Causes

Rising Labor Costs. Soaring real labor costs were, in our judgment, a major component of Spain's post-1974 economic problems (see figure 7). In addition to hurting export competitiveness, the higher costs slashed business profits and deterred hiring and investment. From 1970 to 1983, total real labor costs [1] jumped 124 percent, nearly double the average in the four major West European countries and close to 10 times the increase in the United States. A large part of the increase can be traced to politically motivated concessions to the trade unions in the final days of the Franco regime and during the transition period. During 1975-79 real per-worker costs soared over 8 percent annually, with rising social security charges accounting for about half of this figure. Productivity, meanwhile, grew at an average annual rate of only 1 percent. Firms consequently saw their real unit labor costs—which had been steady during the previous decade—surge 50 percent in five years. 25X1

Figure 7
Spain: Index of Real Unit Labor Costs, 1964-83[a]



[a] The Spanish Government did not collect data for labor costs or productivity prior to 1964.

Note: Real unit labor costs were measured by deflating the industrial labor cost index by the wholesale price index and dividing by the industrial productivity index.

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The situation has improved since 1979 when the recession began to encourage a new spirit of cooperation between labor and management. In particular, the National Bargaining Agreement in 1980 has slowed real wage growth to an average of only 1 percent per year in the early 1980s. Although industrial growth has stagnated, productivity has risen by 5 percent annually on average since 1980 because of the large numbers of layoffs. Despite these recent reductions in real unit labor costs, they still stood about 26 percent higher at the end of 1983 than a decade earlier. 25X1

[1] Real labor costs are defined as total wage and nonwage payments, including contributions to social security. 25X1

Structural Problems. A large part of Spain's problems grew out of the Franco regime's efforts to industrialize the country. To their credit, the development programs reduced the share of agriculture in GDP from 27 percent in 1960 to 12 percent in 1970 and increased the share of industry from 34 percent to close to 40 percent. The programs had been targeted, however, at mining and lower technology sectors. Thus, at the start of the 1970s, steel, shipbuilding, textiles, clothing, and leather accounted for 28 percent of Spain's industrial production.[2] In the four major West European countries, on the other hand, these "sunset" sectors accounted for between 14 and 22 percent of industrial production. These were the very sectors where worldwide surplus capacity and stiff competition from newly industrializing countries emerged later in the 1970s.

Mistimed Investment Surge. Spain's 1960-74 investment boom unfortunately peaked just as Spain's major markets were plunging into recession. During 1972-74, real investment in machinery and equipment soared almost 60 percent—an expansion that was rivaled only by Turkey within the OECD during this period. Such a growth rate could not have been sustained in any event, but in this case the new capacity was coming on line just as world demand was falling. Spanish firms thus found themselves saddled with excess capacity and high fixed costs—undermining both their incentive and their ability to carry out further investment.

Demographic Developments. In our judgment, changes in demographic trends can account for only a small part of the worsening of Spanish unemployment since 1974. Partly because of the turnaround in net emigration, the growth of the working-age population accelerated from 0.8 percent annually during 1960-74 to 1.2 percent annually during 1975-82. If the earlier growth rate had been maintained, the labor force in 1983 would have been about 300,000 to 400,000 smaller than it actually was, and unemployment presumably would have been reduced by a similar amount.

[2] Wood, cork, paper, rubber products, and processed foods represented another 24 percent of industrial production; the remaining half was distributed between mining, energy, chemicals, and equipment production.

Labor force growth actually slowed during 1975-83, however, as the higher population growth was more than offset by a decline in labor force participation rates. The decline was due largely to discouraged workers withdrawing from the labor market, although part of it may represent people finding jobs in the underground economy. In any event, the participation rate for men plunged an average of 1.5 percentage points a year between 1974 and 1982, about twice the rate of decline recorded during 1960-74. The female participation rate, meanwhile, showed no change between 1974 and 1982, in contrast to its 7-percentage-point rise during the earlier period. If the previous male and female participation rate trends had continued through 1982, the labor force would have been larger than the actually reported figure by some 1.2-1.3 million people, and the official jobless total would 25X1
have been correspondingly higher. 25X1

Government Policies. *Social Security Taxes.* Post-Franco Spain has relied heavily on corporate taxes to fund sharply expanded welfare benefits. Employers' contributions made up 77 percent of total social security revenues in 1975, and large and medium-sized corporations, which could not easily evade taxes, have borne most of the burden. Subsequent governments have recognized the damaging impact on industrial profits and competitiveness and have attempted to shift the expense toward the state and employees. Budgetary restrictions and growing unemployment, however, have limited progress; employers' contribu- 25X1
tions were still 62 percent of total revenues in 1983.
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Labor Laws. Paternalistic labor laws inherited from the Franco era have limited the ability of firms to lay off or release workers. Although intended to protect jobs, such laws ultimately reduce employment by discouraging employers from taking on new workers. Attempts to reform labor regulations have been belated and sometimes counterproductive. It was not until 1980 that Parliament passed the Workers Statute; this legislation made layoffs slightly less difficult, but it provided also for high separation payments and 25X1
stipulated that employers could be forced to pay an

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indemnity of three and a half years of basic pay if labor authorities found dismissals unjust.[3] In addition, until 1981, firms could not legally hire temporary workers, and even now the number of such workers is limited by law to a small percentage of the permanent work force. The intention of this restriction was to encourage full-time hiring, but the regulations governing working hours made it cheaper to pay overtime. [redacted]

The introduction of collective bargaining has made wage settlements more rigid. Agreements reached at the national level between the unions and the employers' association establish a narrow band within which wage settlements must be negotiated at the company level. Wage increases are no longer tied to productivity, as in Franco's day. This, along with the uniformity of wage hikes across sectors and companies, has particularly hurt small firms operating on the margin and in the less dynamic sectors. [redacted]

Weak Public-Sector Enterprises. Madrid has compounded structural problems with misguided investment projects and efforts to shore up ailing state firms. In continuing to subsidize dying industries, the government failed to allocate its resources to productive investment and taxed more efficient industries, at an appreciable cost to economic growth. Management mistakes and slowness in adjusting to both domestic and worldwide economic conditions in other sectors sent total losses in public-sector enterprises up from $150 million in 1975 to $2.5 billion in 1983, about 2 percent of GDP. Publicly owned companies—which account for 85 percent of shipbuilding production and 42 percent of steel production—have been major losers since the collapse of these markets in the mid-1970s. As late as 1979, however, Spain was still opening up new facilities to build oil tankers when other industrial countries had already begun reconversion programs in their shipbuilding industries. In the steel industry, public and private Spanish producers, assuming a domestic market of 20 million tons of steel per year, boosted steel production by 18 percent from 1975 to 1983. Domestic consumption, however, sank about 20 percent to 8 million tons by the end of last year. [redacted]

Oil Price Controls. Partly out of fear of exacerbating inflation, Madrid did not raise domestic petroleum prices or enact a national energy plan until almost six years after the 1973 OPEC price hikes. As a result, the country had the poorest oil conservation record within the OECD during the period between the two oil crises, increasing its vulnerability to the second crisis. Between 1973 and 1980, Spanish oil consumption rose 34 percent, while overall energy consumption rose 32 percent; both increases were the second highest in the OECD. More significantly, the ratio of oil consumption per unit of real GDP rose 13 percent during this period. Only one other OECD country—Portugal—recorded an increase in this index during this period; most countries had large decreases (see table 2). If Spain had been able to reduce its oil/GDP ratio by 10 percent during 1973-80—which would still have been the sixth-poorest performance among OECD countries—its 1980 oil import bill would have been about $2.3 billion lower and the 1980 current account deficit would have been cut almost in half. [redacted]

Spain's energy situation began to improve when Madrid passed a national energy plan and raised oil prices in 1979. The main objectives of the plan were to dampen demand; reduce dependence on oil imports; and diversify sources of energy by eliminating oil price subsidies, investing in nuclear facilities, and encouraging coal production. From 1980 to 1983 oil consumption fell 9 percent, while oil use per unit of GDP declined 12 percent—returning it to the 1973 level. The decline in oil consumption, coupled with the weakening of world oil prices, enabled Spain to reduce its oil import bill by over $3 billion during this period. [redacted]

Exchange Rate Policy. By our estimates, the Spanish exchange rate has tended to be overvalued, in varying degrees, throughout the postoil crisis period (see figure 8). A competitive exchange rate was an important prop of the 1960-74 boom; when inflation in the mid-1960s began to erode the impact of the huge 1959 devaluation, another devaluation in 1967 helped to

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[3] The Workers Statute also granted laborers the right to strike. The resulting increases in lost man-hours were an additional factor that cut into industrial profits. [redacted]

Table 2
OECD: Trends in Real GDP and Oil Consumption

1973=100

	Real GDP		Oil Consumption		Oil/GDP Ratio	
	1980	1983	1980	1983	1980	1983
Denmark	112.5	118.2	76.0	58.1	67.6	49.2
Japan	130.0	143.9	88.3	76.5	67.9	53.2
Ireland	134.8	141.8	109.3	77.8	81.1	54.9
France	121.4	125.1	86.3	70.1	71.1	56.0
Belgium/Luxembourg	119.1	119.5	84.4	67.3	70.9	56.3
United Kingdom	106.4	111.5	71.4	64.0	67.1	57.4
Netherlands	122.7	121.0	93.2	70.5	76.0	58.3
Sweden	113.0	115.3	85.0	68.0	75.2	59.0
Finland	121.8	131.1	96.2	78.2	79.0	59.6
Norway	139.0	146.0	91.9	88.4	66.1	60.5
Iceland	123.9	117.2	80.9	72.1	65.3	61.5
West Germany	117.7	117.4	87.6	73.3	74.4	62.4
Canada	122.2	124.3	104.7	79.5	85.7	64.0
Austria	122.6	126.1	103.4	84.7	84.3	67.2
United States	117.6	122.3	97.1	85.6	82.6	70.0
Italy	121.2	119.4	94.5	85.6	78.0	71.7
New Zealand	107.2	113.6	105.6	92.9	98.5	81.8
Switzerland	102.2	102.3	87.1	83.7	85.2	81.8
Australia	118.3	125.3	110.3	111.9	93.2	89.3
Turkey	131.7	148.2	119.4	134.7	90.7	90.9
Greece	126.6	126.3	124.0	115.0	97.9	91.1
Spain	**117.8**	**122.3**	**133.5**	**121.7**	**113.3**	**99.5**
Portugal	124.3	134.9	134.9	149.2	108.5	110.6

Source: *The BP Statistical Review of World Energy*. The calculation of oil consumption includes bunkers.

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restore it. Our index of Spanish competitiveness [4] was already beginning to slip again in 1973, and the OPEC price hikes that year added to the need for a downward exchange rate adjustment to help Spain cope with its oil bill. Madrid refused to devalue, however, and a surge of inflation worsened the situation further; by the end of 1975, the competitiveness index was above the level that had prompted the 1967 devaluation. A devaluation was finally implemented in 1977, but it restored competitiveness only to the 1973 level; moreover, soaring inflation rapidly wiped out its impact. By the middle of 1979, Spanish competitiveness, according to our index, was even worse than it had been before the 1959 devaluation. Exchange rate adjustments since then—particularly in 1982—have improved the situation considerably, although competitiveness is not quite back to the 1973 level.

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[4] We defined competitiveness as the ratio of Spanish consumer price inflation to a trade-weighted average of inflation in competitor countries, adjusted for exchange rate fluctuations.

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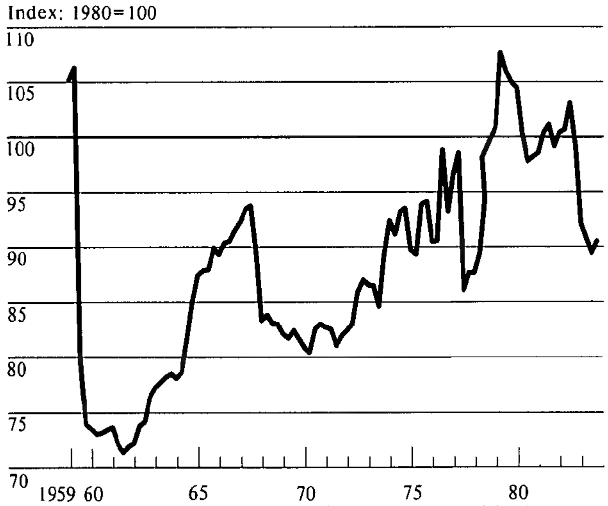
Figure 8
Spain: Index of Competitiveness, 1959-83, by Quarter [a]



[a] The ratio of Spanish consumer price inflation to a trade-weighted average of inflation in competitor countries, adjusted for exchange rate fluctuations. A decrease in the index indicates an improvement in competitiveness.

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Efforts To Cure the Problems

Efforts by Earlier Governments

Madrid was slow to respond to the worsening economy in the early 1970s, probably because the leadership was preoccupied by the effort to establish democracy. Indeed, we believe government policy generally was making things worse during this period. In response to growing current account deficits in the middle 1970s, the centrist government led by Adolfo Suarez launched the Moncloa Pact—an austerity plan in 1977 to which all the major political parties subscribed—and agreed upon additional measures with the IMF in 1978 in exchange for a $185 million standby loan. The stabilization program involved tight monetary policy, a slight decrease in the budget deficit, wage ceilings for public-sector employees, and wage guidelines for the private sector. Austerity measures led to a momentary improvement in the current account in 1978-79, but domestic demand stagnated. Spanish authorities then eased their policies in 1979 to stimulate GDP, but the second round of oil price hikes forced an immediate change of tactics. Madrid tried to support economic growth and simultaneously narrow its current account deficit with an expansionary fiscal policy and a somewhat restrictive monetary policy in 1980-82. The policies were not compatible—although the government allowed the budget deficit to nearly quadruple to 6 percent of GDP, it did not permit sufficient monetary growth to satisfy the borrowing needs of both the government and the private sector. As a result, interest rates rose, contributing to a fall in investment. 25X1

Centrist governments experimented with a variety of largely unsuccessful schemes in the early 1980s to hold unemployment down. In addition to revising labor laws in the Workers Statute and absorbing more of the cost of social security, they introduced tax incentives and public works projects, reduced permissible overtime, and set a higher minimum working age. The Suarez government also persuaded trade unions to accept a cut in real wages under the 1981 National Employment Pact (ANE) in exchange for a commitment to promote the creation of 350,000 new jobs. Nevertheless, the unemployment rate had risen above 16 percent by the time of the 1982 election campaign. 25X1 25X1

The government also began drafting an industrial restructuring program as early as 1977, but no comprehensive plan was introduced until 1981. The four-year program aimed at increasing productivity by eliminating job redundancies, consolidating firms to take advantage of economies of scale, promoting research and development, cutting capacity, and providing financial assistance to ease the burden of adjustment. In all, 11 sectors fell under the reconversion scheme, including textiles, footwear, steel, shipbuilding, and electrical appliance and components industries. Implementation of the plan was slow, however, and when the Socialists took power in 1982, only 300 of 8,800 target firms had received approvals for financial assistance under the plan. 25X1

Efforts by the Socialist Government

Surprising those who thought it might take the same expansionary/inflationary route followed by new Socialist governments in France and Greece, the Gonzalez administration instead concentrated on restoring

economic stability. It moved quickly to establish and maintain a more realistic exchange rate, although perhaps not going far enough in this area. Madrid also introduced a stringent monetarist policy and reined in government spending. To date, the Gonzalez administration has made considerable progress in reducing the current account deficit and has brought the inflation rate and budget deficit down somewhat.

We judge the centerpiece of Socialist longer term economic strategy to be the industrial reconversion program, which was picked up from the previous government and expanded. The Gonzalez government has vowed to complete the program within three years and to prune weak industries vigorously. According to the Socialist plan, 63,500 workers—9.5 percent of the labor force in the affected sectors—will be laid off. An additional 135,000 workers will probably lose their jobs in support industries indirectly affected by reconversion.

The Socialists particularly want to reallocate resources to industries with a greater growth potential. They plan to foster investment in auto production, electronics, food processing, and defense materials through government subsidies, direct credits, credit guarantees, tax exemptions, investment incentives, and labor subsidies. To minimize worker dislocations, investment will be targeted at the geographic areas most affected by reconversion. The Gonzalez government is also designing retraining programs and providing unemployment compensation to cushion the effects of restructuring.

A major goal of the program is to restore the health of the public-sector enterprises. Of the $7 billion budgeted for the reconversion program, 70 percent will go to state-owned firms to help scale down sick industries, support investment in new areas, and improve the companies' debt ratios. In addition, the Gonzalez government is developing plans to sell to the private sector the state's stock in some of the major money losers, which had been taken over by the Franco regime to protect jobs. Madrid thus hopes to bring public-sector companies' budgets close to balance by 1986 and reduce the burden to the state over the longer run. Initially, however, Madrid probably will have to accept a loss to entice buyers for the firms.

Another key element of Socialist strategy is the new national energy plan, aimed at reducing Spain's dependence on oil imports by cutting oil's share of total primary energy consumption to 47 percent by 1992. To accomplish this, the combined share of hydropower and nuclear energy is to climb to 23.1 percent, up from 11.3 percent in 1982, while the share of natural gas is to increase from 3.2 percent in 1982 to 4.6 percent. Madrid hopes to reach these targets by 25X1 promoting energy conservation through realistic pricing policies and by encouraging substitution through credits and subsidies. The government also will provide financial support to boost coal production, keeping coal's share at about 25 percent. The Socialists project that the plan will cost $7.3 billion and generate 97,000 jobs from 1984 to 1992. We are skeptical that Madrid can achieve all these goals, particularly because the plan requires substantial investments to convert from oil to gas and to distribute gas. 25X1

The Socialist record on employment promotion is 25X1 mixed. On the positive side, they are not relying on government programs to create jobs but instead are trying to boost employment by moderating real wages and revising labor laws. Madrid has extracted the Socialist General Union of Workers (UGT) trade union's agreement to a wage band next year of 5.5 to 7.5 percent, versus the government's 8-percent inflation target. In 1986, wages are set to rise by 90 to 107 percent of the actual 1985 inflation rate. To stimulate employment, particularly among youth, Madrid has also eliminated the obligation to pay an indemnity to laid-off workers. The measure applies only to new hires; workers brought in under the old regulations 25X1 are not affected. Madrid also has put youths under 25 on their parents' social security benefit plan, thus allowing employers to hire young people without making social security payments. 25X1

On the negative side, the Gonzalez administration has implemented some measures that tend to discourage hiring. By reducing the number of temporary workers who can be hired, the maximum length of their

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contracts, and the number of hours in the workweek, the government has, in our view, reintroduced some rigidities into the system. Other factors, not under its control, also have worked against it. With the impact of lower real wages and labor market reforms expected to have a lag of about a year, the Socialists have been obliged to watch the unemployment rate reach 20 percent.

Prospects

The Short-Term Outlook

Spain appears to be on the road to a modest recovery. We expect real GDP this year to show an increase of about 2.5 percent, due mostly to a strong export performance. Gains in competitiveness from the 8-percent devaluation of the peseta in December 1982 and a narrower inflation differential, together with the incipient recovery in Western Europe, should boost export volume by more than 10 percent for the year as a whole. Private consumption and real investment, however, are showing signs of weakening. The government's tight fiscal policy probably will hold the growth of public consumption to 2.5 percent. Consequently, domestic demand and imports should be up only slightly, allowing Madrid to turn last year's $2.5 billion current account deficit into a surplus of about $1 billion. Slack demand, lower import prices, and a moderation of wage gains should help to shave another 3 percentage points off the inflation rate.

Coming close to achieving most of its goals this year and doing better than expected in the external sector, the Gonzalez administration apparently believes that it can afford to relax its monetary stance over the near term. Madrid has persuaded domestic bankers to lower interest rates by 1.5 percentage points and has allowed faster liquidity growth to accommodate this reduction. The Socialists hope to stimulate investment in interest-rate-sensitive sectors, such as construction and consumer durables, and to promote employment. During negotiations with the UGT and business leaders, the government agreed to expand unemployment compensation coverage and create 160,000 to 190,000 public-sector jobs but made it clear that it will not retreat from its intention of reducing the budget deficit to 4.5 percent of GDP by 1986. Madrid is increasing taxes, slowing the growth of real public-sector investment, and cutting public-sector employees' real wages 1.4 percent next year to achieve its goal. 25X1

Assuming the Socialists do not abandon the objectives of their austerity program, GDP will probably expand by close to 3 percent annually in 1985 and 1986. 25X1
Higher taxes to keep the budget deficit in line, real wage losses, and a lagged response to lower interest rates and labor law reforms probably will limit private consumption and investment growth. Firms may respond to real wage cuts and greater labor market flexibility by hiring more workers, but the slow pace of economic growth and demographic trends suggest that little or no improvement in the unemployment rate is likely in the next few years. 25X1

We thus expect the unemployment rate—Madrid's most serious problem—to stay near 20 percent, at least for the next year or two. In our view, the economy cannot absorb the 70,000 to 100,000 people that the Bank of Spain estimates will enter the job market annually, and only a few will be able to emigrate to northern Europe. We believe that the Socialists probably cannot promote the creation of enough jobs in new industries and in the services sector to offset job losses resulting from the industrial reconversion program. In addition, agricultural employment will undoubtedly continue to fall, albeit less sharply than in the past because of the aging of the 25X1
farm population over the last two decades. 25X1

The trade unions' willingness to discuss wage guidelines and other labor issues with the government and the employers' association suggests that high unemployment probably will not lead to serious social disruptions. We believe union leaders will hesitate to do anything that could undermine the Gonzalez government as long as the opposition is headed by the rightwing leader of the Popular Alliance, Manuel Fraga de Iribarne. Although the Communist-dominated Workers Commissions (CCOO) labor union would not sign the social pact, it has less support than

the UGT and little potential for mobilizing nationwide strikes. Sporadic demonstrations against the government's program to cut jobs in weak industries are likely to continue, but the Socialists will probably be able to head off an escalation of strike activity by offering compromises.

The structure of unemployment in Spain should also keep social tensions down. The fact that more than one-half of the jobless are youths between 16 and 24, many of whom still live at home, suggests that the family support system will continue to ease some of the pain of unemployment. Among 25- to 54-year-old men, the actual unemployment rate is probably lower than the 11.6-percent official estimate because of the hidden economy.

There are downside risks, and our 3-percent annual growth forecast for 1985-86 could be optimistic. As the unemployment rolls mount, workers may feel that they have been asked to carry an unfair share of the burden of adjustment. Because past worker sacrifices have not yet led to any tangible benefits, the trade unions may turn increasingly against the Gonzalez government's pleas for further sacrifices. If workers mount stronger opposition to the industrial reconversion program, it could damage the Socialists' plans for making Spanish industry competitive. Moreover, if the government fails to bring down public-sector credit demands, private investment will be crowded out.

If the economy is still mired in recession as the 1986 election nears, the Gonzalez administration may consider expansionary policies. Under this scenario, Gonzalez probably would have to sack Finance Minister Miguel Boyer, the architect of the austerity program. We consider this unlikely because of Gonzalez's assertions that he will pursue an adjustment program in spite of the potential political losses in the next election and because of his strong support for Boyer. Moreover, Madrid clearly hopes to avoid making the same mistakes as President Mitterrand initially did in France, where the 1981 expansionary program simply boosted inflation, put the current account deep in the red, and caused a run on the franc. In any case, Madrid would have to weigh the short-run political mileage from relaxing its policies against the probability of having to apply the brakes again later on.

On balance, we believe that it is highly unlikely that the Gonzalez government will water down its industrial reconversion program—a topic that probably will stay on the political front burner because it directly affects workers' interests. Government officials probably recognize that they cannot bring unemployment below 19 percent by 1986 as promised, even if workers cooperate and real GDP grows faster than targeted. With little to be gained from a policy change, we expect the Socialists to stay on their present course, mitigating worker unrest by laying more emphasis on the labor benefits available under the industrial reconversion program, giving less publicity to the belt tightening necessary, and offering compromises to the UGT that will allow it to keep its followers in line.

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The Longer Term Outlook

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Although longer term forecasts are always shaky, we feel reasonably certain that the next decade will be better for the Spanish economy than the last one. In the first place, the external environment should be more favorable because it is unlikely that the next 10 years will see a combination of two sharp oil price hikes and two severe international recessions. In the second place, Spanish economic policymaking is now on a sounder footing. Although there are still important problems, it does not seem probable that the major policy errors of the 1970s will be repeated.

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One encouraging sign is the diversification and expansion of Spain's export base. In 1970, agricultural commodities represented over one-third of total exports; manufactured goods accounted for only slightly more than half, and these manufactures were highly concentrated in a few traditional sectors. By 1982, food exports had declined to 16 percent of total exports, and manufactures had risen to 71 percent and had a somewhat more varied composition. Although traditional goods remain important, Spain has diversified its export sector by moving into the production of automobiles, cement, machinery parts, domestic appliances, plastics, and chemicals. On the negative side,

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Table 3
Export Specialization [a]

	Spain		European Community		NICs [b]	
	1970	1982	1970	1982	1970	1979
Steel	0.3	1.9	1.1	1.0	0.3	0.5
Ships	3.3	1.6	1.0	0.5	0.2	1.4
Textiles	0.8	1.1	1.2	1.2	1.2	1.9
Leather	2.5	4.3	1.7	1.5	0.8	1.0
Footwear	7.3	4.7	1.8	1.3	1.5	3.2
Automobiles	0.2	1.2	1.2	1.0	0	0.1
Trucks	0.3	0.8	0.8	0.8	0.1	0.3
Rubber manufactures	2.3	2.2	1.1	1.1	0.2	0.9
Mineral manufactures [c]	1.3	4.9	1.3	1.2	0.3	0.7
Domestic appliances	1.2	1.3	1.3	1.2	0.2	1.0
Electric appliances	0.5	0.7	1.1	0.9	0.9	0.5
Chemicals	0.6	0.8	1.0	1.2	0.4	0.3
Plastics	0.2	0.6	1.1	1.3	0.1	0.2
Medicine	0.5	0.7	1.3	1.2	0.9	0.4
Scientific instruments	0.2	0.2	0.9	1.0	0.1	0.3
Heavy industrial machinery	0.6	0.6	1.2	1.0	0.1	0.2
Telecommunications equipment	0.4	0.4	1.0	0.8	0.1	0.7
Machine parts	0.6	1.0	1.3	1.2	0.4	0.3
Business machinery	0.4	0.5	0.9	0.8	0.3	0.6

[a] This is defined as the proportion of exports of a given sector in relation to total exports for a country, divided by the proportion of OECD exports in that sector to total OECD exports. An indicator greater than 1 indicates "specialization" in that sector, according to the definition.

As the table shows, Spanish-manufactured exports were highly concentrated in traditional sectors in 1970. Like the NICs, Spain has gradually moved into other sectors such as automobiles and plastics; however, it remains weak in high-technology commodities like telecommunications equipment. The industrial reconversioin program should help diversify Spanish exports, but it will be a long time before they are as evenly distributed as the EC's.

[b] Newly Industrializing Countries (NICs). The most recent available data are 1979.

[c] The major components are construction materials, such as cement, asbestos, lime, and bricks; glass; and ceramics.

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Spain still lags behind the European Community in the infrastructure needed to export either capital-intensive goods or high-technology commodities where world demand has grown rapidly (see table 3).

On the other hand, we think a return to the high growth rates posted during the miracle years is out of the question. Madrid still has a long way to go in solving its economic problems, and we believe this will hold average growth through 1990 to perhaps 3 percent annually. With the labor force still expanding at about 1 percent per year, this means that relatively little progress will be made against unemployment. 25X1

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With most forecasters expecting Western Europe as a whole to grow by no more than 2.4 percent annually for the remainder of the decade, the prospects for Spanish emigration and 1960s-style export growth are not bright. Slow progress in industrial reconversion means that, optimistically, Madrid could not hope to

be in a strong competitive position before 1987. Moreover, as a result of early retirements under the reconversion program and demographic factors, social security will become an increasing burden. With the number of pensioners jumping by nearly 30 percent from 1983 to 1990, Madrid projects social security expenditures at 14.2 percent of GDP in 1990, versus 12.3 percent last year. Financing benefits for both pensioners and the army of unemployed will keep taxes high and drain resources that might otherwise go into investment.

The small size of most Spanish firms could also be a serious impediment to growth in the increasingly competitive, high-technology environment of the 1980s. As early as 1959, the Franco government recognized the problem of undersized firms and sought to promote mergers. These efforts had little effect, however, perhaps due to a lack of entrepreneurial skill, to complacency, or to bureaucratic red-tape. In 1975, less than 1 percent of all companies employed 500 or more workers, the same as in 1958. The percentage of medium-sized firms actually fell, reflecting a sharp increase in the number of bankruptcies that probably stemmed from steep labor costs, slow sales, and liquidity problems. Even today, more than 90 percent of Spanish companies employ fewer than 25 people. Equipment in these small firms often is obsolete, productivity has remained at less than one-half the EC level, and the product quality is sometimes poor. In addition, the smaller enterprises generally sell to the protected domestic market and thus contribute little to the drive to expand exports.[5]

Another problem for the longer term is that Madrid still pursues a comparatively protective trade policy, which has allowed uncompetitive firms to survive. Although Madrid lowered tariffs in 1970, trade barriers remain considerably higher than in the EC. The average Spanish tariff on EC goods, for example, is 13.3 percent, versus an average EC tariff on Spanish products of only 3.3 percent. Similarly, Madrid's tariffs on goods from third countries average about 17 percent—more than triple the average common external tariff in the EC. Shielded from international competition, Spanish firms have had less reason to invest in new equipment or to improve the quality of their merchandise. 25X1

EC accession—which may take place in 1986—thus may not initially bring many rewards. The transition years, during which Spain will have to lower its tariffs to EC levels, seem likely to produce considerable economic strain. Some inefficient industries, previously protected by high import barriers, will probably go bankrupt with the onslaught of increased competition from the north. Meanwhile, some of the benefits of membership—especially the elimination of EC barriers on Spanish agricultural exports—will be delayed under the terms of accession, which aim to protect the Ten's domestic interests as long as possible. 25X1

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[5] The Spanish Government has estimated that about 75 percent of domestic firms do not export.